# The Fed Takes One Step at a Time

- **The Fed tapered Treasury and MBS purchases as expected…**
- **...and remains on track to shut them down by next summer**
- **A discussion on reinvestment will occur in future meetings**
- **Powell passed on the opportunity to tamp down 2022 rate hike pricing…**
- **...which means it's a 'live' option**
- **The FOMC's confidence in 'transitory' has weakened**
- **2022H1 flagged as key to evaluating wage pressures**
- **The USD softened, Treasuries bear steepened and stocks rallied**

The Federal Reserve broadly met expectations in kicking off the start of its well telegraphed plans to reduce its purchases of Treasuries and Mortgage-Backed Securities. Chair Powell did not engage when given the opportunity to refute market pricing around rate hikes in 2022 which leaves the option on the table. Part of the reason for this reticence is that the FOMC slightly watered down its confidence around transitory drivers of inflation and 2022H1 was positioned as key to observing wage pressures. I think the December meeting is being set up for a possible shift by the median FOMC vote toward lifting off in 2022. Minutes to the meeting three weeks hence are unlikely to contain any dialogue around either timing rate lift-off or reinvestment plans.

As a result, the US 10 year yield climbed by just over 3bps while the 2 year yield held roughly unchanged, the dollar marginally depreciated and the S&P500 gained ¾% after the start of communications at 2pmET. It could have been a more hawkish set of communications relative to what was already priced, so markets expressed a bit of relief for now.

What follows is a break down of the salient points drawn from the statement (here), the NY Fed's accompanying implementation notice (here) and after listening to Chair Powell's press conference in full.

## WHAT THE FED DID ON PURCHASES

Most had expected a shift toward reducing the pace of purchases by $10 billion per month in Treasuries and $5B per month in MBS and that's what the Fed delivered. The language referenced 'at least' $70B of Treasury purchases and 'at least' $35B of MBS purchases 'beginning later this month'.

Chair Powell explained in the press conference that the reason to provide advance guidance for December's flow today was because the NY Fed has to announce its schedule before the next FOMC meeting in December. Therefore, the statement not only noted November's reduced flow, but also pre-committed to a purchase reduction to 'at least' $60B and $30B in December.

The path is largely a straight line thereafter. "Similar reductions" are being targeted at successive meetings which indicates a steady $15B combined reduction in

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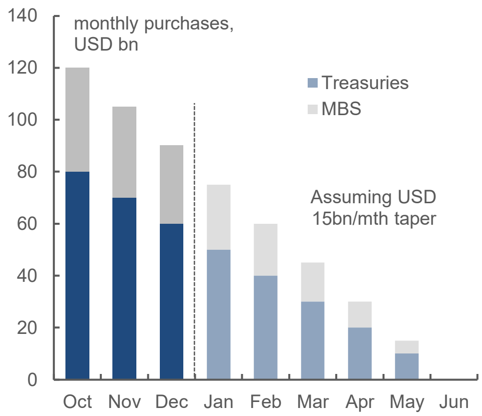
Chart 1

The Fed's Taper Path




Sources: Scotiabank Economics.

purchases at each meeting until they are down to zero. That puts the Fed on target to end net purchases by next June in keeping with our expectations (chart 1).

The committee did qualify that ‘it is prepared to adjust the pace of purchases if warranted by changes in the economic outlook.” Thus, the FOMC retained some flexibility both in terms of “at least” and the willingness to adjust.

When asked “Why are you tapering faster this time than in 2013–14?” Powell explained the stark differences between back then and now. He emphasized that “We were much farther from maximum employment then. Today demand is very, very strong so the need for further stimulus is far less than in 2013 when we still had a long ways to go. This is quite a different situation.” He might have added that inflation has ripped this time and wasn’t doing so in the post-GFC era!

## REINVESTMENT PLANS SAVED FOR A LATER DATE

Powell said that in coming meetings they'll talk about reinvestment and there will be a series of briefings and discussions. In other words, don’t look for discussion on reinvestment in the coming minutes.

## LESS CONFIDENCE IN ‘TRANSITORY’ INFLATION

The statement also tweaked the language around inflation by stating that pressures on inflation are now “expected” to be transitory versus the earlier treatment that made it more of a statement of fact. That introduces a bit more uncertainty around whether inflationary pressures will dissipate and that was likely necessary to avoid dissenting votes by some of the committee’s more hawkish members.

The description around inflation also now includes reference to how “Supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable price increases in some sectors.” Here too “contributed” is less ironclad in that it leaves open a role for other drivers of inflationary pressure.

When further probed during the press conference, Powell generally reinforced his view that the drivers of inflation are expected to be transitory and by corollary so is somewhat of a soft patch for growth that could improve as bottlenecks dissipate. He has softened his guidance on this issue rather markedly over the year including the pivot at the September meeting that the price stability goal has been met after previously spending much of his time dismissing temporary inflation. Powell’s expectation is that inflation will decline toward the 2% longer run goal as supply chain issues dissipate.

Frankly, I wouldn’t expect the Fed Chair to say anything less. There is one aspect of what he is saying that reflects his beliefs. There may very well be another aspect that reflects his role as chief communicator seeking to avoid dislodging market fears around how the Fed is viewing inflationary pressures. Nevertheless, even a return to 2% inflation—if achieved—is compatible with rate hikes in a more normalized post-pandemic world that no longer requires the same stimulus and that may require hikes to achieve it.

## 2022H1 CRITICAL TO EVALUATING WAGE PRESSURES

When probed on what the acceleration of wage pressures means, Powell said that the Employment Cost Index reading indicates “we're close to back to zero in real terms for wage gains.” Whether that’s true or not depends upon whether one takes year-over-year measures or q/q annualized measures that do a better but more volatile job at capturing inflection points.

He went on to say that “The concern would be an unusual case where wages are sustainably rising faster than productivity gains. We don't have evidence yet of a wage-price spiral. The ECI reading is just one reading. We'll be watching this carefully but at this point we don't see troubling signs.”

I would say that this interpretation is vulnerable to a pivot over 2022H1 if nascent evidence of wage pressures builds upon itself. Key in terms of durable wage gains is that the Fed—like so many—doesn’t know where maximum employment sits. Powell said **“There is room for a whole lot of humility here in terms of assessing maximum employment and we're learning. We hope to have clarity over the first half of next year."**

My personal bias remains that this shock hit boomers at the point of retirement much more so than the GFC. Boomers are roughly between their mid-50s to mid-70s with most in their 60s. Eventually they all came back after the GFC but I’m not sure they will do so again now since many more were likely getting toward retirement or changing the nature of their work as the pandemic hit. In other words, the Fed may be overestimating the gap between present employment conditions and full employment and we could already be there or very close to it. Powell would never say that, at least not at this juncture.

## WANING DELTA INFLUENCES

The statement also acknowledged the improvement in COVID-19 cases by embracing the past tense in shifting the reference to "the summer's" rise in COVID-19 cases.

## FORWARD RATE GUIDANCE—THE FED DID NOT LEAN AGAINST 2022 HIKE PRICING

There is nothing in the statement itself that hints at when the FOMC is thinking of raising the policy rate. To see otherwise is employing a rather heaping dose of literary licence. In fact, Powell bluntly stated that the taper timeline "does not imply any direct signal on our interest rate policy" and repeated that the two decisions face different criteria (ie: substantial further progress versus maximum employment).

Further, Powell also made it clear that the meeting did not discuss lift-off. He said “We have not focused on when to lift off because we haven't met those conditions now. We were focused upon the purchase decision. We're not evaluating the lift-off test today and did not have that discussion today."

That means we probably won’t see anything on life-off in the meeting minutes three weeks from now. Powell said “The focus at this meeting is on tapering not raising rates. We don't think it's time yet to raise interest rates. There is still ground to cover before getting to maximum employment. We expect elevated inflation well into next year. Inflation will decline as supply chain issues subside by Q2 or Q3 as growth constraints dissipate. We will be watching carefully to see if the economy evolves in line with our expectations.”

Still, when asked, Powell did say that he thinks maximum employment can be achieved by the second half of next year and that “It is certainly within the realm of possibility.” By extension, that means rate hikes are also possible then.

Indeed, when asked whether markets are wrong in expecting 1–2 hikes next year, Powell fumbled with his papers and read scripted responses that largely ducked the question. In short, **not confronting market pricing was a tacit refusal to reject 2022 rate hikes as a possibility.**

When further pressed on inflation and lift-off, Powell gave his clearest indication yet that the Fed is willing to act on any persistent upside in inflationary pressures. He said "For now the risk appears to be skewed higher so we need to be prepared to act and we will be. We'll be patient but we won't hesitate" when the time comes to hike. He went on to state “It boils down to common sense, to risk management. The risks of significantly higher inflation persisting well into next year requires us to be in a position to address that risk if it drives higher long run expectations.”

So stay tuned. For now, our forecast is for a first rate hike in December 2022. To bring it forward may require strong job gains and persistent inflation, but it would likely have to be brought considerably ahead of the November 2022 mid-term elections that the Fed is likely to avoid.

Please see the attached statement comparison.

**RELEASE DATE: November 3, 2021**

The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals.

With progress on vaccinations and strong policy support, indicators of economic activity and employment have continued to strengthen. The sectors most adversely affected by the pandemic have improved in recent months, ***but the summer's rise*** in COVID-19 cases has slowed their recovery. Inflation is elevated, largely reflecting factors that are ***expected to be*** transitory. ***Supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable price increases in some sectors.*** Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The path of the economy continues to depend on the course of the virus. Progress on vaccinations ***and an easing of supply constraints are expected*** to support continued gains in economic activity and employment as well as a reduction in inflation. Risks to the economic outlook remain.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation having run persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved. The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. ***In light of the substantial further progress the economy has made toward the Committee's goals since last*** December, the Committee ***decided to begin reducing the monthly pace of its net asset purchases by $10 billion for Treasury securities and $5 billion for agency mortgage-backed securities. Beginning later this month, the Committee will*** increase its holdings of Treasury securities by at least $70 billion per month and of agency mortgage-backed securities by at least $35 billion per month. ***Beginning in December, the Committee will increase its holdings of Treasury securities by at least $60 billion per month and of agency mortgage-backed securities by at least $30 billion per month. The Committee*** judges that ***similar reductions*** in the pace of ***net*** asset purchases ***will likely be appropriate each month, but it is prepared to adjust the pace of purchases if warranted by changes in the economic outlook. The Federal Reserve's ongoing purchases and holdings of securities will continue to*** foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Thomas I. Barkin; Raphael W. Bostic; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Mary C. Daly; Charles L. Evans; Randal K. Quarles; and Christopher J. Waller.

**RELEASE DATE: September 22, 2021**

The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals.

With progress on vaccinations and strong policy support, indicators of economic activity and employment have continued to strengthen. The sectors most adversely affected by the pandemic have improved in recent months, but the rise in COVID-19 cases has slowed their recovery. Inflation is elevated, largely reflecting transitory factors. Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The path of the economy continues to depend on the course of the virus. Progress on vaccinations ~~will likely continue~~ to ~~reduce the effects of the public health crisis on the economy, but risks~~ to the economic outlook remain.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation having run persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved. The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. ~~Last~~ December, the Committee ~~indicated that it would continue to~~ increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month ~~until substantial further progress has been made toward its maximum employment and price stability goals. Since then, the economy has made progress toward these goals. If progress continues broadly as expected, the Committee~~ judges that ~~a moderation~~ in the pace of ~~asset purchases may soon be warranted~~. These asset purchases help foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

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